Internal Revenue Service

memorandum

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Br2:LSMannix

date: AUG 18 1989

to: Regional Counsel, Midwest CC:MW
Attn: Lawrence C. Letkewicz
Special Trial Attorney

from: Assistant Chief Counsel (Tax Litigation) CC:TL

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subject: [redacted]

This responds to your request for Tax Litigation Advice of May 25, 1989. The case is calendared for trial in [redacted].

ISSUE

Whether a franchise granted by a municipality to the operator of a cable television system constitutes a franchise for purposes of I.R.C. § 1253.

CONCLUSION

A cable television franchise is not a franchise for purposes of section 1253. The legislative history shows that Congress intended section 1253 to apply to a specific kind of arrangement, exemplified by the Dairy Queen cases. A cable television franchise is not such an arrangement.

FACTS

According to your memorandum of May 25, 1989, the facts are as follows:

Petitioner [redacted] operator of cable television systems, serving in excess of [redacted] subscribers in [redacted] states. It has also been [redacted] operators in acquisitions of existing franchises from other operators. For example, during the years [redacted] and [redacted] alone, [redacted] acquired [redacted] different cable television franchises for which it claimed amortization deductions on its returns. Total amortization of franchise costs claimed by [redacted] on its returns for the years [redacted] through [redacted] exceeded $[redacted]. Although [redacted] prior to [redacted] amortized its franchise costs over the remaining term of the franchise agreements under I.R.C. § 167, [redacted] now contends that it is entitled to amortization under section 1253(d) over the life of the agreement or [redacted] years, whichever is less.

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During the year [redacted], [redacted] acquired [redacted] separate cable systems from [redacted], a subsidiary not part of the [redacted] consolidated group in which it held a [redacted]% interest, for an aggregate price of $[redacted]. [redacted] allocated approximately $[redacted] of the purchase price to tangible assets and the remaining $[redacted] to franchise costs, which it seeks to amortize under section 1253. 1/

The present case involves the taxable year [redacted] and arises as a result of the Service's disallowance of a claimed net operating loss carryback deduction in that year from [redacted]. The [redacted] District is currently in the process of completing its examination of the taxable year [redacted] as well as auditing the years [redacted] and [redacted]. The statute of limitations for [redacted] and [redacted] also remains open under an open-ended consent.

The impetus for [redacted]'s claim that it is entitled to amortize its franchise costs under section 1253 is Rev. Rul. 88-24, 1988-1 C.B. 491, which holds that the transferee of the initial franchise holder is entitled to amortize the portion of the purchase price allocable to the cost of the franchise under section 1253. Accordingly, [redacted] is clearly entitled to amortization of franchise costs under section 1253 unless the cable television systems which it operates do not constitute franchises within the meaning of that section.

Due to the [redacted] acquisitions made by [redacted] and in the cable industry generally since [redacted], the issue which is the subject of this request has a potential revenue impact far exceeding the relatively small deficiency in the present case. Accordingly, you have requested our views and comments.

DISCUSSION

Background

A cable television franchise is a grant of a privilege or license to a private company (the cable operator) by a municipality or county government (the franchising authority), embodied in an ordinance, which gives the cable operator the authority to construct, maintain and operate a cable television system. The franchise grants the cable operator an easement over public property, including streets and tunnels, for the purpose

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1/ Your initial analysis of the case suggests that the allocation of $[redacted] to tangible assets is probably correct. You do, however, expect to challenge [redacted] on the amount properly allocable to franchise costs for purposes of either section 1253 or 167.

of laying cable, erecting poles and maintaining other cable television equipment within the jurisdiction of the franchising authority.

In response to a variety of problems surrounding the explosive growth of cable television, Congress enacted the Cable Communications Act of 1984. Pub. L. 98-549, § 2, 98 Stat. 2780-2801, codified at, 47 U.S.C.A. §§ 521-559 (Supp. 1989) (the 1984 Cable Act). The stated purpose of the 1984 Cable Act was, among other things, to "establish guidelines for the exercise of Federal, State, and local authority with respect to the regulation of cable systems." 47 U.S.C.A. § 521(3). The 1984 Cable Act essentially leaves the regulation of cable television franchises to the local franchising authorities but strictly prescribes the regulations in order to assure the cable system is responsive to the needs of the local community. Rollins Cablevue, Inc. v. Saienni, 633 F.Supp. 1315 (D. Del. 1986). The 1984 Cable Act essentially leaves the local franchising process intact.

Many franchising authorities designated cable television franchises "franchises" for the purposes of state and/or municipal law and some states designated the franchises "public utilities" (although the franchises cannot be regulated as a public utility pursuant to the 1984 Cable Act. 47 U.S.C.A. § 541(c)). As a result of these designations, many states require cable television franchises to be awarded only through a bidding process and some states require the award of the franchise be ratified by a town vote. Courts have upheld these designations or have made such a designation when a franchising authority has failed to do so. TV Pix, Inc. v. Taylor, 396 U.S. 556 (1970), aff'g per curiam 304 F.Supp. 459 (D. Nev. 1968); Heather Corporation v. Community Telecommunications, Inc., 677 P.2d 330 (Colo. 1984); Borough of Scottdale v. National Cable TV Corporation, 368 A.2d 1323 (Pa. Comwlth. 1977); Springfield Television, Inc. v. City of Springfield, Missouri, 462 F.2d 21 (8th Cir. 1972); Aberdeen Cable TV Service v. City of Aberdeen, 85 S.D. 57, 176 N.W.2d 738 (1970), cert. denied, 400 U.S. 991 (1971); Illinois Broadcasting Company v. City of Decatur, 96 Ill. App. 2d 454, 238 N.E.2d 261 (1968); Kornegay v. City of Raleigh, 269 N.C. 155, 152 S.E.2d 186 (1967).

As stated above, the 1984 Cable Act prescribes the requirements that a franchising authority can impose on a cable operator. Under the 1984 Cable Act a franchising authority may:

> (1) require the cable operator to maintain minimum standards of service, such as making available a minimum number of channels and maintaining a minimum standard for picture and audio quality, 47 U.S.C.A. § 544;

(2) designate certain channels for public, educational or governmental use, 47 U.S.C.A. § 531;

(3) charge a franchise fee not in excess of 5% of the cable operator's gross annual revenues, 47 U.S.C.A. § 542;

(4) set price controls for basic cable services but only if the cable operator is not subject to effective competition, 47 U.S.C.A. § 543; 2/

(5) give preference to cable operators with local or minority ownership in the awarding of cable franchises, H. Rep. No. 934, 98th Cong., 2d Sess., 19, reprinted in, 1984 U.S. Code Cong. & Admin. News 4655, 4664;

(6) prohibit the transmission of obscene materials, 47 U.S.C.A. §§ 532(h), 544(d), 559.

A franchising authority cannot impose any other restrictions on the cable operator and it is expressly forbidden from regulating the content of cable television. 47 U.S.C.A. §§ 533(e), 544(b), 544(f). Most cable franchise agreements contain the requirements permitted by the 1984 Cable Act, except price controls, and some, but not all, require the payment of a franchise fee.

A cable television franchise is typically for a term of 15 years. However, it is often renewed as matter of course. See Toledo TV Cable Company v. Commissioner, 55 T.C. 1107 (1971), aff'd per curium, 483 F.2d 1398 (9th Cir. 1973) (The Tax Court held that because the cable television franchise had been renewed and was likely to be renewed again as a matter of course, it had no ascertainable useful life). But see Chronicle Publishing Company v. Commissioner, 67 T.C. 964 (1977) (The Court held that the petitioner carried his burden of proof in showing that the cable television franchise had an ascertainable useful life because there was no renewal provision in the franchise agreement, the regulation of the industry was in a state of flux and there was increased competition between cable operators for the franchise).

The 1984 Cable Act now prescribes optional procedures for renewal of cable television franchises. (A cable operator can

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2/ Through its definition of the term "effective competition," the Federal Communications Commission has effectively prevented most franchising authorities from setting price controls on basic cable services. 47 C.F.R. § 76.33(2). See Note, The End of Government Regulation of the Rates Cable Television Services Charge Their Subscribers, 5 Cardozo Art & Ent. L.J. 157 (1986).

require the franchising authority to adopt the procedures or a franchising authority may adopt the procedure on its own initiative.) These procedures are designed to protect the existing cable operator while still allowing the franchising authority the ability to meet community needs. H. Rep. No. 934, 98th Cong., 2d Sess., 19, reprinted in, 1984 U.S. Code Cong. & Admin. News 4655, 4662.

Essentially, the franchise can only be revoked if the cable operator is not providing cable television service in a satisfactory manner. 47 U.S.C.A. § 546(c)(1). The cable operator can also appeal the revocation or denial of renewal to a court of law. 47 U.S.C.A. § 546(e). In addition, if the cable television franchise is properly revoked or its renewal denied, the cable operator must be compensated for the cable system it installed. 47 U.S.C.A. § 547. These safeguards added by the 1984 Cable Act now make it more likely that a cable franchise will be renewed as a matter of course and that, therefore, the franchise has no ascertainable useful life for federal income tax purposes.

The tax issue arises here when a cable operator sells its business to a third party (hereinafter referred to as a "taxpayer"). Among the assets sold is the cable television franchise. (Typically, a cable operator must receive permission from the franchising authority before assigning its rights in the franchise to the taxpayer.) Taxpayers are allocating a portion of the purchase price to the cable television franchise and amortizing this cost over the 10 year period prescribed in section 1253(d)(2)(A).

In order to avail itself of section 1253(d)(2)(A), the taxpayer must use Rev. Rul. 88-24, 1988-1 C.B. 306. Otherwise, under section 1253(a), the sale would be deemed a sale or exchange of a capital asset because the original cable operator has not retained any significant power, right or continuing interest in the franchise. Thus, under a literal reading of the statute, the taxpayer could only amortize the cost of the franchise if it had an ascertainable useful life.

Rev. Rul. 88-24, however, allows the taxpayer to amortize the cost of the franchise under section 1253(d)(2)(A) if the franchising authority retains any significant power, right or continuing interest, as defined in section 1253(b)(2), in the franchise. Taxpayers are arguing that franchising authorities retain significant powers, rights and continuing interests because franchising authorities typically retain the right to: (1) disapprove any assignment of the franchise (section 1253(b)(2)(A)); (2) prescribe the standards of quality of services furnished (section 1253(b)(2)(C)); and (3) in some

cases, the franchising authorities require the payment of a franchise fee based on use (section 1253(b)(2)(F)).

However, section 1253 only applies to a "franchise" as defined in section 1253(b)(1). Thus, the initial question is whether a cable television franchise is a "franchise" as defined by section 1253(b)(1).

Legal Analysis

I. Legislative history should be examined in order to determine whether Congress intended section 1253 to apply to cable television franchises.

There are certain litigation hazards in connection with arguing that a cable television franchise is not a "franchise" as defined in section 1253(b)(1) and is, therefore, not within the scope of section 1253. These hazards stem from a direct reading of section 1253. However, legislative history should be examined to determine whether Congress intended section 1253 to apply to cable television franchises.

Section 1253(b)(1) states: "The term 'franchise' includes an agreement which gives one of the parties to the agreement the right to distribute, sell, or provide goods, services, or facilities, within a specified area."

Section 7701(c) states: "The terms 'includes' and 'including' when used in a definition contained in this title [the Internal Revenue Code] shall not be deemed to exclude other things otherwise within the meaning of the term defined." Thus, under a literal reading of section 1253(b)(1), an "agreement which gives one of the parties to the agreement the right to distribute, sell, or provide goods, services, or facilities, within a specified area" is within the meaning of the term "franchise" as used in section 1253(b)(1) and "other things otherwise within the meaning of the term..." are within the term "Franchise," as used in section 1253(b)(1).

Taxpayers are likely to argue that a cable television franchise is, in essence, an agreement which gives the cable operator the right to provide services within a specified area and, thus, a cable franchise falls within the literal definition of a "franchise" in section 1253. If it is assumed that a cable franchise is, in essence, such an agreement, it would appear that recourse to the legislative history of section 1253 would be barred by the general rule of statutory construction which prohibits reference to legislative history if a statute is unambiguous on its face. See Gilbert v. Commissioner, 241 F.2d 491 (9th Cir. 1957); Flex-O-Glass, Inc. v. United States, 3

AFTR2d 1034 (N.D. Ill. 1959). Thus, taxpayers will likely argue that the analysis ends here.

Furthermore, as previously discussed, a cable franchise has been held to be a traditional public franchise by a variety of courts and, thus, it may be argued that a cable franchise would be a thing otherwise within the meaning of the term "franchise."

However, notwithstanding these arguments, recourse may still be made to the legislative history of section 1253 in order to determine whether Congress intended section 1253 to cover cable television franchises. There is an exception to the general rule that if a statute is unambiguous on its face, recourse may not be made to its legislative history. In Lartobe Steel Company v. Commissioner, 62 T.C. 456, 462 (1974), the Tax Court stated:

> Although a literal interpretation of the first sentence of section 404(a) would appear to support the position of respondent, we are not confined to such a literal reading in order to construe the intended meaning of this section. Rather, it is our duty to give effect to the intent of Congress by interpreting the general words of a section with reference to the whole statute, the purpose for which it was enacted, and its antecedent history. Helvering v. N.Y. Trust Co., 292 U.S. 455 (1934). * * *

In Lartobe Steel, the Tax Court construed the statutory language at issue more narrowly than a literal interpretation would have warranted, after a review of the legislative history. In a more recent case, the Tax Court stated:

> In addition, we may seek out any reliable evidence as to the legislative purpose even where the statute is clear. United States v. American Trucking Associations, Inc., 310 U.S. 534, 543-544 (1940); U.S. Padding Corp. v. Commissioner, [88 T.C. 177, (1987) aff'd, 865 F.2d 750 (6th Cir. 1989)]; Estate of Baumgardner v. Commissioner, 85 T.C. 445, 451 (1985); Huntsberry v. Commissioner, 83 T.C. 742, 747-748 (1984); J.C. Penney Co. v. Commissioner, [37 T.C. 1013, 1019 (1962), aff'd, 312 F.2d 65 (2d Cir. 1962)].

Centel Communications Company, Inc. v. Commissioner, 92 T.C. No. 34 (March 23, 1989). The purpose of this exception to the general rule is to give effect to the legislature's intent, which is the first and most important rule of statutory interpretation. Helvering v. N.Y. Trust Co., 292 U.S. 455, 464 (1934).

Therefore, even though section 1253(b)(1) may be unambiguous on its face, recourse may still be made to the legislative history in order to determine whether Congress intended section 1253 to cover cable television franchises. And, upon examination

of the legislative history, it will become clear that Congress intended section 1253 to cover a specific kind of arrangement that does not include a cable television franchise.

Alternatively, Sutherland Stat. Const. § 45.02 (4th Ed.) permits examination of the legislative history to section 1253 in the instant case. It states:

> A frequently encountered rule of statutory interpretation asserts that a statute, clear and unambiguous on its face, need not and cannot be interpreted by a court and that only statutes which are of doubtful meaning are subject to the process of statutory interpretation. ...However, this rule is deceptive in that it implies that words have intrinsic meaning. A word is merely a symbol which can be used to refer to different things. For example the word "automobile" has fairly determinate content and is not likely to cause great difficulty in interpretation; but the word "bill" may refer to an evidence of indebtedness, to currency, to a petition, to a person's name, to the anatomy of a bird, a portion of a cap and a host of other objects, and may need "interpretation" and "construction." * * *
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> ...Before the true meaning of a statute can be determined where there is genuine uncertainty concerning its applications, consideration must be given to the problem in society to which the legislature addressed itself. Prior legislative consideration of the problem, the legislative history of the statute under litigation, and the operation and administration of the statute prior to litigation are of equal importance.
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> When a court declares a statute ambiguous, it asserts that some of the words used may refer to several objects and the manner of their use does not disclose the particular objects to which the words refer. [endnotes omitted]

In the instant case, there is a genuine ambiguity as to what the term "franchise" in section 1253(b)(1) refers because the term has two distinct and well defined meanings and it is unclear from the face of the statute whether Congress intended section 1253 to apply to both types of franchises or to just one, or the other, type of franchise. (The term franchise can refer to a public franchise or a private business franchise. The difference between the two types of franchises is discussed later.) Although section 1253(b)(1) attempts to define the term "franchise," it only makes reference to one type of arrangement and there is no other guidance as to what else is within its scope.

It should also be noted that the maxim of ejusdem generis (of the same kind, class or nature) applies in this case. The maxim holds that where specific words follow general ones, the general term is restricted to things that are similar to the things enumerated. Sutherland Stat. Const. § 47.17 (4th Ed.) Thus, under ejusdem generis, the term "franchise" would be restricted to things similar to the type of arrangement enumerated in section 1253(b)(1).

Because it is unclear what types of arrangements are within the scope of section 1253, it is necessary to consult the legislative history.

II. The legislative history shows that Congress intended section 1253 to apply to private business franchises of the type at issue in the Dairy Queen cases.

Congress enacted section 1253 in response to a line of cases commonly referred to as the "Dairy Queen" cases. Both the House and the Senate reports discuss and cite these cases. H. Rep. No. 413, 91st Cong., 1st Sess., 1, 160-163, 1969-3 C.B. 200, 300-301; S. Rep. No. 552, 91st Cong., 1st Sess., 1, 205-209, 1969-3 C.B. 423, 554-555. All the Dairy Queen cases involved the transfer of private business franchises. (All the cases cited by the House and Senate, except for two, involved actual Dairy Queen franchises.) All the franchises were exclusive distributorships limited to specific geographical areas.

The issue in each of the cases was whether there had been a sale or exchange of a capital asset or merely the transfer of a license in a franchise. If there was a sale or exchange, the transferror/taxpayer received capital gain treatment and if there was merely the transfer of a license, the transferror/taxpayer received ordinary income treatment.

In most of the cases the issue of whether there was a sale or exchange turned on the amount of control the transferror/taxpayer retained over the franchise. If the transferror/taxpayer retained significant control over the franchise, the courts held that there was merely a transfer of a license in a franchise and the transferror/taxpayer received ordinary gain treatment.

The issue in the Dairy Queen cases, as described above, is the issue addressed by section 1253. In fact, section 1253 addresses the question of whether there is a sale or exchange in the same manner that most of the Dairy Queen cases addressed the issue. Under section 1253, if the transferror retains any significant power, right or continuing interest over the

franchise, there is merely a transfer of a license and the transferror receives ordinary income treatment.

With respect to the issue of whether a transferror retains any significant power, right or continuing interest in a franchise, both the House and Senate reports couch their discussion in terms that would only be applicable to a private business franchises of the type at issue in the Dairy Queen cases. The House Report states:

> The following are some examples of the types of powers or rights which have been retained by franchisors: (1) the franchisee may not move equipment obtained from the franchisor outside of the territory in which he may operate; (2) the franchisee must purchase specified equipment from the franchisor; (3) the franchisee is required to periodically supply specified information regarding his operations to the franchisor; (4) the manner in which the franchisee conducts his operations are subject to the approval of the franchisor, such as prohibiting the sale of certain products; and (5) the franchisor may withdraw the franchise if the franchisee fails to develop his territory.

The next paragraph of the report states:

> In other words, it would appear that the franchisor has reserved what may be regarded as an operational interest in the subfranchise if he participates in its management by conducting activities such as sales promotion (including advertising), sales and management training, employee training programs, holding of national meetings for franchisees, providing the franchisee with blueprints or formulas, and other forms of continuing assistance.

H. Rep. No. 413, supra., 1969-3 C.B. at 301. The Senate Report contains substantially the same language. S. Rep. No. 552, supra., 1969-3 C.B. at 555-556. Most of the quoted discussion would only apply to private business franchises and there are other parts of the reports that would also only be applicable to private business franchises.

The original version of the bill which ultimately became section 1253 was passed by the House Ways and Means Committee. The bill defined a "franchise" as follows: "The term 'franchise' means a franchise, distributorship, or other like interest." With respect to this version, the Report of the House Ways and Means Committee states: "The term 'franchise' is defined by the bill to mean a franchise, distributorship, or other like interest. This would include subfranchises, subdistributorships, and other similar exclusive type contract arrangements to operate

a trade or business." H. Rep. No. 413, supra, 1969-3 C.B. at 302.

The Senate Finance Committee adopted a different definition of the term "franchise" and its version ultimately became section 1253(b)(1). The Senate Finance Committee Report states:

> the term "franchise" includes an agreement which gives one of the parties to the agreement the right to distribute, sell, or provide goods, services, or facilities, within a specified area. This would include distributorships or other similar exclusive-type contract arrangements to operate or conduct a trade or business within a specified area, such as a geographical area to which the business activity of the transferee is limited by the agreement. However, the committee amendments provide that the new rules are not to apply to the transfer of a franchise to engage in a professional sport. * * * The House bill did not define "franchise" in detail, but would have applied [the new section] to professional sport franchises.

S. Rep. No. 552, supra, 1969-3 C.B. at 557. (Section 1253(e) specifically exempts sport franchises from the application of section 1253.)

The House and Senate Committees' discussion of the definition of a franchise, when taken in context, shows that Congress was attempting to define the type of franchise at issue in the Dairy Queen cases. The sentence: "This would include subfranchises, subdistributorships, and other similar exclusive type contract arrangements to operate a trade or business," in the House Report and the sentence: "This would include distributorships or other similar exclusive-type contract arrangements to operate or conduct a trade or business within a specified area, such as a geographical area to which the business activity of the transferee is limited by the agreement" in the Senate Report describe the franchises at issue in the Dairy Queen cases.

Furthermore, the version adopted by the Finance Committee and ultimately used in the statute was an attempt to describe the attributes of the Dairy Queen franchises rather than merely stating that section 1253 covers "franchises, distributorships, or other like interest," as was done by the House Committee. As stated by the Finance Committee, the House did not attempt to define a "franchise" in detail. The Finance Committee Report, on the other hand, states that its definition covers "distributorships or other similar exclusive-type contract arrangements to operate or conduct a trade or business within a

specified area" or, in other words, the definition in the statute covers the type of franchise at issue in the Dairy Queen cases.

In addition, the phrase "distributorship or other similar exclusive-type contract" (emphasis supplied) in the Senate Report and the phrases " distributorship, or other like interest" and "subdistributorships, and other exclusive type arrangements" (emphasis supplied) in the House Report is evidence that Congress intended section 1253 to cover franchises essentially similar to the franchises in the Dairy Queen cases. This position is supported by the maxim ejusdem generis, discussed above.

The above analysis leads to the conclusion that Congress intended section 1253 to apply to private business franchises of the type that was at issue in the Dairy Queen cases. First, Congress enacted section 1253 in response to the Dairy Queen cases and used the same approach as was used in those cases. And, all the franchises in the Dairy Queen cases were private business franchises. Second, the discussion of the definition of a franchise in the committee reports, and the statutory definition, is essentially an attempt to define the franchises at issue in the Dairy Queen cases. Third, the phrase "distributorship or other similar exclusive-type contract" in the Senate Report and the phrases " distributorship, or other like interest" and "subdistributorships, and other exclusive type arrangements" in the House Report is evidence that Congress intended section 1253 to cover franchises essentially similar to the franchises in the Dairy Queen cases.

III. The type of private business franchises at issue in the Dairy Queen cases have several characteristics that distinguish them from a cable television franchise.

The type of franchise at issue in the Dairy Queen cases has several distinguishing characteristics. These characteristics have been incorporated into the definitions of a "franchise" adopted by the Federal Trade Commission (FTC) and various states with respect to franchiser disclosure rules and other rules relating to private business franchises. 16 C.F.R. § 436.1(a). See, for example, N.Y. Franchises Law § 681 (McKinney 1984); Del. Code Ann. tit. 6, § 2551 (1975). The FTC's definition, which is similar to the various state definitions (and which is notably similar to Congress' description of franchise in the legislative history to section 1253, quoted above), is substantially as follows.

> (a) The term "franchise" means any continuing commercial relationship created by any arrangement or arrangements whereby:

(1)(i)(A) a person (hereinafter "franchisee") offers sells, or distributes to any person other than a "franchisor" (as hereinafter defined), goods, commodities, or services which are:

(1) Identified by a trademark, service mark, trade name, advertising or other commercial symbol designating another person (hereinafter "franchisor"); or

(2) Indirectly or directly required or advised to meet the quality standards prescribed by another person (hereinafter "franchisor") where the franchisee operates under a name using the trademark, service mark, trade name, advertising or other commercial symbol designating the franchisor; and

(B)(1) The franchisor exerts or has authority to exert a significant degree of control over the franchisee's method of operation, including but not limited to, the franchisee's business organization, promotional activities, management, marketing plan or business affairs; or

(2) The franchisor gives significant assistance to the franchisee in the latter's method of operation, including, but not limited to, the franchisee's business organization, management, marketing plan, promotional activities, or business affairs; * * *

* * *

and

(2) The franchisee is required as a condition of obtaining or commencing the franchise operation to make a payment or commitment to pay to the franchisor, or to a person affiliated with the franchisor.

16 C.F.R. § 436.1(a).

This definition, the various state definitions and the characteristics of the franchises at issue in the Dairy Queen cases can be distilled down into three general characteristics. These are: (1) the franchisee is granted the right to engage in the business of distributing, selling, or providing goods, services, or facilities under a marketing plan or system prescribed in substantial part by the franchiser; (2) the operation of the business is associated with the franchiser's trademark, service mark, logo or other commercial symbol designating the franchiser; and (3) the franchisee is required to make one or more payments, directly or indirectly, to the franchiser.

When these characteristics are applied to a cable television franchise, it becomes clear that a cable franchise is not the type of franchise envisioned by Congress as within the scope of section 1253. First, the franchising authority for a cable franchise does not prescribe a marketing plan for the cable operator. There are usually minimum standards prescribed by the franchising authority on the service that must be provided by the cable operator; but, as previously stated, the franchising authority cannot control the content of cable television, which is the actual product being offered by the cable operator. Furthermore, the franchising authority does not prescribe how a cable operator should market its services or products, solicit customers or advertise. Second, there is no trademark or trade name associated with a cable franchise. And third, only some franchising authorities require a franchise fee.

Therefore, under the above analysis, a cable television franchise is not a franchise within the scope of section 1253.

In this context, it should be noted that the only published Service document that defines a "franchise" is Rev. Rul. 87-63, 1987-2 C.B. 210. Rev. Rul. 87-63 holds that "a license agreement to receive computerized commodity trading suggestions does not constitute a franchise under section 1253 of the Code...." The revenue ruling states that the rationale for the holding is that Congress did not intend section 1253 to apply to this type of arrangement as evidenced by the Senate Finance Committee Report (quoted above). The revenue ruling states that Congress intended section 1253 "to apply to systems of distributions generally characterized by many or all of the traditional indicia of franchise arrangements. These include the continued use by the franchisee of the franchiser's trade name and trademarks, quality controls by the franchisers, management and operational guidance, and common advertising and promotion by the franchiser, within a specified area."

Rev. Rul. 87-63 assumes that the only type of franchise that is within the scope of section 1253 is a private business franchise of the type at issue in the Dairy Queen cases. As stated above, there is no use of the franchiser's trade name or trademark with a cable television franchise. There is a certain amount of quality control over the cable service; but, as stated above, federal law prohibits the franchising authority from controlling the content of cable television, which is, in fact, the product being provided by the cable operator. And, there is no management and operational guidance or common advertising and promotion with a cable television franchise. Thus, under Rev. Rul. 87-63, a cable television franchise is also not within the scope of section 1253.

IV. Alternatively, a cable television franchise is not an agreement which gives one of the parties to the agreement the right to distribute, sell, or provide goods, services, or facilities, within a specified area and, therefore, it is not a franchise within the definition of section 1253(b)(1).

A cable television franchise is not an agreement which gives one of the parties to the agreement the right to distribute, sell, or provide goods, services, or facilities, within a specified area. Rather, a cable television franchise is a grant of a privilege or license by a governmental entity. A brief review of the law of franchises will illuminate the distinction.

The term "franchise" has two distinct and well defined meanings. In Black's Law Dictionary (5th Ed.), the term "franchise" has two definitions. The first is: "A special privilege conferred by government on individual or corporation, and which does not belong to citizens of country generally of common right." The second is: "A privilege granted or sold, such as to use a name or to sell products or services. The right given by a manufacturer or supplier to a retailer to use his products and name on terms and conditions mutually agreed upon."

With respect to these two different definitions, two well developed and entirely distinct bodies of law have developed. In Community Tele-Communications, Inc. v. Heather Corporation, supra, the Supreme Court of Colorado quoted the Eighth Circuit's discussion of a public franchise as follows:

> "A franchise is a right or privilege granted by the sovereignty to one or more parties to do some act or acts which they could not perform without this grant from the sovereign power. * * *
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> "A right or privilege which is essential to the performance of the general function or purpose of the grantee, and which is and can be granted by the sovereignty alone, such as the right or privilege of a corporation to operate an ordinary or commercial railroad, a street railroad, city waterworks or gasworks, and to collect tolls therefor, is a franchise....
>
> "A right or privilege not essential to the general function or purpose of the grantee, and of such a nature that a private party might grant a like right or privilege upon his property, such as a temporary or revocable permission to occupy or use a portion of some public ground, highway, or street, is a license and not a franchise."

Id., 677 P.2d at 337, quoting, McPhee & McGinnity Company v. Union Pacific Railroad Company, 158 F. 5, 10 (8th Cir. 1907).

On the other hand, as stated above, the FTC and various states adopted a completely different definition for a "franchise," for the purpose of franchiser disclosure rules and other rules relating to private business franchises,.

Thus, the two concepts are entirely different. A public franchise consists of a grant or a privilege conferred by a government and a private business franchise consists of an agreement of the type essentially described in section 1253(b)(1).

The two types of franchises are also mutually exclusive. A public franchise cannot be a private business franchise and visa versa.

We believe that Congress intended section 1253 to cover private business franchises because the definition in section 1253(b)(1) does not mention the grant of a privilege or license by a governmental entity. Resort to the legislative history, as discussed above, confirms this conclusion.

V. The contra argument is that public franchises should be treated like private business franchises for purposes of federal income taxation.

One case cited by both the Tax Court and the Fifth Circuit in the Dairy Queen case Moberg v. Commissioner, 35 T.C. 773, 784 (1961), aff'd, 305 F.2d 800, 804 (5th Cir. 1962), involved a public franchise. In that case, Jones v. United States, 96 F.Supp. 973 (D. Colo. 1951), aff'd, 194 F.2d 783 (10th Cir. 1952), the taxpayer sold his interest in a municipal bus franchise, which was held in a partnership, to the other partner. The issue was whether the taxpayer should receive capital gain or ordinary income treatment on the sale in light of the fact that he received compensation in the form of half the rent from a lease that existed on the bus franchise.

Although the courts' opinions in Jones are unclear, the courts in Moberg cite the Jones case for two propositions. The Tax Court cites the case for the proposition that merely because a transferror is a licensee does not bar the possibility of a sale, as opposed to a transfer of a mere license in a franchise. The Fifth Circuit cites the case for the proposition that capital gain treatment is not lost by providing for payments contingent on future sales. (Section 1253 now requires that such payments be ordinary income.)

The Jones case presents another significant litigation hazard with respect to the instant issue primarily because it stands for the proposition that the same issues that arose in the

Dairy Queen cases and that led to the enactment of section 1253 can arise in the context of public franchises. And, there appears to be no reason not to apply the same principles that exist in section 1253 to the transfer of public franchises. This argument can be countered by arguing that the Jones case was not cited in the legislative history to section 1253 and, as shown above, Congress only considered private business franchises when it enacted section 1253.

RECOMMENDATION

For the reasons outlined above, the instant issue should be defended. Furthermore, the administrative importance of this issue is substantial. Because the term "franchise," pursuant to section 1253(b)(1), has not been defined by the courts, taxpayers are attempting to include a large variety of arrangements within its definition to take advantage of the amortization provided by section 1253(d)(2) and Rev. Rul. 88-24. The instant issue should be the Service's first line of defense against an overly broad definition of the term.

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